After a Spate of Scandals, A Debate on New Rules

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PROMPTED by tales of fund-raising fraud, conflicts of interest and bloated overhead, a number of state and federal legislators are working to create new rules for nonprofit groups.

In California, the Nonprofit Integrity Act, embodying a sweeping set of changes, was signed into law by Gov. Arnold Schwarzenegger in late September.

Other changes have come in other guises. In the federal arena, legislation has been enacted as part of the recent corporate tax cuts to eliminate excessive deductions for donations of vehicles and intellectual property. The Internal Revenue Service has stepped up its enforcement of existing laws and regulations. Inspired, at least in part, by the Sarbanes-Oxley Act of 2002, which strengthened corporate auditing procedures and made executives more accountable, the Senate Finance Committee has also proposed numerous regulatory reforms, which are still under discussion and not a bill yet.

"I'm not looking for the big, bad monster of a government bureaucrat coming down on a sector," said Senator Charles E. Grassley, Republican of Iowa, who is the committee's chairman. "But we need to make sure that money taken in for charitable purposes is used for charitable purposes."

Here is an overview of major developments:

Proposed Federal Legislation

The Senate Finance Committee's proposal would require a periodic review of an organization's tax-exempt status; include other charities within the scope of the self-dealing rules that currently govern foundations; and "improve the quality and scope" of tax form 990, which nonprofits must file annually with the I.R.S.

The legislation would also widen the scope of the financial documents that would be available to the public and require independent audits of financial statements for exempt organizations with more than $250,000 in gross annual receipts.

In perhaps its most far-reaching and controversial provisions, the proposal would delve into areas now largely reserved for states, encouraging "strong governance and best practices" among nonprofits by imposing specific fiduciary duties on board members and giving the I.R.S. authority to seek the removal of board members or officers who violate the rules.

The United States Tax Court would be given new equity powers, including the ability to rescind transactions entered into by nonprofits. Directors and trustees of nonprofit groups would also be able to bring court proceedings on behalf of the organizations they serve, if they think there are improprieties.

Other whistle-blowers would be able to submit complaints directly to the I.R.S. The agency would also be given enough money to perform its enforcement tasks.

The proposal has caused quite a stir in the nonprofit sector.

There are many who favor it, like William Josephson, the former assistant attorney general at the New York State Charities Bureau. "It addresses a very comprehensive catalog of concerns about deficiencies in the philanthropic regulatory scheme at the federal level," Mr. Josephson said.

Pablo Eisenberg, a senior fellow at the Georgetown Public Policy Institute, agrees. His group conducted a study last year analyzing payments by foundations to their trustees that found, among other things, that sizable payments are frequently made for less than sizable amounts of work. "We need new regulations to prevent these abuses," he said.

But others are not as certain. Sheri A. Brady, public policy director of the National Council of Nonprofit Associations in Washington, said that most problems among nonprofit groups resulted not from "trying to take advantage of the system but from ignorance." And she worries that charities may be put in "the awkward position of being told to cut administrative costs at the same time they are being told to increase administrative expenditures" to comply with stricter rules.

Florence Green, executive director of the California Association of Nonprofits, thinks that the public would best be served

by enforcement of current laws and regulations. "The regulators do not need more rules or regulations to go after the bad guys," she said. "Attorneys general and the I.R.S. already have broad powers to investigate, prosecute and sue nonprofits."

Marion R. Fremont-Smith, a senior research fellow at the Hauser Center for Nonprofit Organizations at Harvard University, also has some criticisms. She said that it was necessary to "clean up" existing I.R.S. provisions and to secure adequate financing for the agency's activities.

But she worries that the prospect of federal liability would discourage people from serving as charity officials. As for the provisions allowing removal of directors, she said that she was "not persuaded" that pre-emption by the federal government was necessary or that, if it were, "it's the Internal Revenue Service that is best suited for the job."

Still, Mr. Josephson thinks that in at least one area, the proposal does not go far enough in regard to the I.R.S.

"Because state regulators are generally attorneys general," he said, "and not 'taxing authorities,' the Internal Revenue Service is not allowed to share information with them under present law. That needs to be changed."

For now, the proposal, which was the subject of a Congressional hearing last July, remains pending. At the request of Senator Grassley and Senator Max Baucus, Democrat of Montana, a further discussion and review by a national panel of experts will be convened by Independent Sector, a coalition of organizations, foundations and corporate philanthropy programs. Its report will be presented to the committee early next year.

Internal Revenue Service

In the meantime, the I.R.S. is "acting to stem abuses" on a number of fronts, said Martha Sullivan, director of exempt organizations for the agency's Tax Exempt and Government Entities division. Among these are increased efforts to stop status abuses, in which tax-exempt entities are used to shield companies or individuals from paying taxes in profit-making, nonexempt transactions.

The I.R.S. has also begun a so-called exempt compensation initiative. In response to many people at nonprofit organizations apparently receiving high salaries and benefit packages, the agency began sending letters in August to various groups, asking for details of their executive compensation. About 200 letters have been sent so far to obtain a statistical sample, Ms. Sullivan said. A total of 2,000 will go out by next September. "Once we get the responses, we will analyze them to determine which ones should be referred for examination," she said.

States

States have the largest role in the regulation of charities. And lawmakers in many states have recently considered increased regulation, much of it relating to financial reporting and executive responsibility, like the Sarbanes-Oxley Act.

Some proposals have yet to become law. For example, a bill introduced last January in Arizona would require charities to certify that 90 percent of their income is used for charitable purposes. Another, in New York, would require verification of annual reports by executives of nonprofit groups. In other states, however, bills have been enacted.

In Maine, a law was passed in March requiring charities to file audited financial statements when renewing their charitable registrations. In New Hampshire, nonprofit groups with revenues in excess of $500,000 must now file audited financial reports with the state's attorney general. And in Massachusetts, the law now requires that charities with annual revenue of more than $500,000 provide the state with a full audit.

In California, a number of new measures have recently become law. Some relate to financial controls, like requiring annual audits for organizations with more than $2 million in revenue and requiring nonprofit boards to review executive compensation. Others focus on fund-raising behavior that has historically been subject to abuse.

For example, nonprofit groups often hire companies to conduct their fund-raising campaigns. According to Steven Gevercer, a deputy attorney general and the legislative advocate for the California attorney general, these charities sometimes end up with little or no benefit from these arrangements, even if a lot of money is raised.

The new law requires commercial fund-raisers to file a statement with the California attorney general detailing, among other things, the methods to be used. There must be a written contract between a charity and a commercial company, and

the charity has the unconditional right to cancel the contract within specified time frames in the absence of fraud, and at any time if there is fraud. And any person convicted of a crime arising from charitable fund solicitation is barred from commercial fund-raising.

Another provision bars commercial fund-raisers who are working for police or firefighter charities from offering the public membership cards, stickers, emblems or any other item that can be displayed in a vehicle and that suggests affiliation with or endorsement by "public safety personnel."

Yet another provision was inspired by a criminal case in Santa Clara County that is still pending, Mr. Gevercer said. Prosecutors have charged that a commercial fund-raiser for a police charity asked people to buy tickets to an event and then "donate" them back so that they might be given to underprivileged children, which apparently never happened.

The law was designed to defuse increasing public skepticism about charities and encourage people to keep on giving, as was the purpose of all the California legislation related to nonprofits.

"The primary goal of the bill was to restore public trust in nonprofits," Mr. Gevercer said. "That's because we know how much good they do."